Emerging market debt Q&A

Market Insight

Co-Heads of Emerging Markets, David Dowsett and Polina Kurdyavko, provide their insight on the macro outlook, default rates, corporate credit, pockets of opportunities and what investors should watch out for heading into the second half of this year.

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We are now mid-way through 2017 and we have seen all emerging market (EM) fixed income asset classes, both sovereign and corporate, hard and local have delivered solid returns year to date. What are your current thoughts on the market from both a top-down and bottom-up perspective?

From a top-down perspective, global growth data is still telling a story of a synchronised global upturn, led by Chinese reflation since mid-2015, but coming in parallel with a sustained US recovery and new found confidence in Europe. Central banks are on the whole still providing accommodative monetary policies and although Chinese authorities are beginning to tighten, it remains manageable. Worries around Trump's protectionist desires seem to have been caged and major geopolitical risks have been contained so far.

Bottom-up presents a mixed picture providing plenty of scope for active investors. Just when investors were turning more constructive on Brazil, the Temer scandal surfaced, raising concern over the sustainability of structural reforms. Venezuela appears to be in a spiral of decline, despite the Maduro regime surprising everyone in terms of its ability to survive and to continue to pay bondholders, while in South Africa, internal battles over the succession to President Zuma are keeping political risks elevated, weighing down on growth and investment. On the other side of the coin, India continues to be a bright spot, with the Modi administration finally making some significant progress on the reform front amidst strong growth and falling inflation. Central and Eastern Europe is another area we favour, as the region as a whole is very strong fiscally as revenues continue to increase, benefits from the strong growth uptick in the eurozone, and from lower oil prices. Turkey is also showing some signs of improvement politically and economically, as the Justice and Development Party (AKP) switch their focus back to investment, growth and employment.

Overall, we believe EM debt is well-placed to benefit in the current environment, one where country specific stories will come to the fore with credit differentiation (alpha) rather than beta plays being the order of the day.

What about the EM corporate debt landscape? In 2016 we saw an increase in default rates, are we now beginning to signs of recovery?

It's true to say that EM companies have experienced some pain over the past 3-5 years – a global growth slowdown, significant devaluation of local currencies, a commodities slump not to mention a number of negative idiosyncratic stories (most notably in Brazil). All of which culminated in broad based deterioration in credit fundamentals (rise in leverage) and a subsequent rise in EM high yield corporate defaults over the past few years, peaking in excess of 5% in 2016.

However, we firmly believe that the worst of the pain is now behind us and that we are in the balance sheet repair phase of the credit cycle. We felt that the cycle turned in the latter half of 2016 and companies are now increasingly focused on further deleveraging through asset sales, bond buybacks, capex cuts and other cost cutting initiatives. This has been particular true in quasi-sovereign segment of the market and in the commodity sensitive sectors such as oil & gas and metals & mining.

At the beginning of this year we forecasted the 2017 default rate to be around 2% and mid-way through the annualised rate stands at 0.6%, far lower than our expectations. If this trend continues, we will be on track for the biggest year-on-year decline in defaults since the aftermath of the Global Financial Crisis. As such, we feel that we are at a pivotal turnaround point for the EM corporate asset class and we feel there are lots of opportunities to generate returns.

Where do you see the most opportunities in the current market across the entire spectrum of EM fixed income asset classes?

EM local currency sovereign debt currently yields 6%+ at index level and in our view presents an attractive investment proposition. We believe that the market is rich with dispersions and full of potential opportunities, particularly as we have recently seen a number of new local markets opening up for foreign investors. After a period of being absent from offshore local markets, Nigeria is easing their capital controls and may soon emerge as one of the more exciting local possibilities. Egypt has regularly allowed foreign access to their Treasury bills offering what in our view are very attractive double digit yields. The Argentine market has also opened for foreign investors, and the country is now part of the local currency index. Lastly, Uruguay has also issued local bonds and is expected to be included in the local currency index too.

From a currency perspective, we feel valuations are particularly attractive given the significant depreciation seen from 2011 up to the low point in 2015. EM currencies have strengthened since then, but even after this rally there is significant scope for further upside when seen in this context. Further to this, our research shows strong growth indicators in both emerging and developed markets and EM currencies we believe are very well positioned to capture this growth momentum. Also, from a technical perspective EM local currency debt still remains relatively under-owned.

We are beginning to see increasing instances of companies also issuing debt in their local currencies. Do you see opportunities in this space?

We see EM local currency corporate debt as one of the most exciting opportunities. Not only is it one of the highest yielding asset classes in the market today but it also is one of the least exposed to underlying interest rates (shortest duration). It is also, on average, investment grade rated. We feel that we are in something of a sweet spot for this asset class as we have a pretty constructive view on both EM currencies and EM interest rates, as well as a constructive view on company fundamentals. So the three drivers of return of this asset class – namely credit, rates and currency – are all aligned.

Over the past 18 months we have witnessed a number of firsts. The opening of the offshore Indian (Masala) corporate bond market, corporates issuing in offshore pesos in Argentina following the country’s return to capital debt markets, we saw the first issuance of offshore Peruvian sol corporate bonds. We also saw the re-opening of some local currency offshore markets that had been shut for over 18 months, including Russia, Czech Republic and Turkey. We expect for these themes to continue on a forward looking basis as more and more markets open and companies look to issue in their domestic currencies as the market continues to evolve and continue to gain traction with the international investor community.

Until recently, the EM local currency corporate debt investor base was primarily comprised of local buyers such as pension funds, banks and insurance companies. We are now seeing interest from international investors and this has translated into an increase in offshore issuance, which makes the asset class more accessible.

Taking out your crystal ball, what do you think the second half of 2017 has in store for EM debt?

We believe that the current market backdrop is friendly for EM fixed income to continue what in our view is its strong run of performance like we have seen for much of this year. Despite renewed inflation fears, growth is seemingly continuing on its positive trajectory. Although we are beginning to hear some more hawkish rhetoric from the Fed and other G7 Central Banks, we remain in a stable interest rate environment for now. This should have a positive knock-on effect for EM currencies which we feel will be a tailwind rather than a headwind over the medium term.

Market technicals are expected to continue remain positive in the second half of the year and beyond, as the “chase for yield” theme remains in play. In this context, we are on track for a record year of inflows to EM debt. While the backdrop of low and declining corporate default rates should provide a strong footing for spreads in the corporate segment of the market to grind tighter.

Undoubtedly there are potential risks to be aware of – not least the recent pullback in commodities prices, heightened China risks, rising geopolitical tensions in the Middle East and in the Korean peninsula, an uptick in political fallout in Brazil. However, we do not believe that any of these should derail the positive outlook that we have for the market over the coming months.

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